

UNITED STATES BANKRUPTCY COURT
DISTRICT OF NEVADA

In re:

THE RHODES COMPANIES, LLC CH: 11 09-14814-LBR
CONTINUED STATUS HEARING RE: OBJECTION
TO JAMES RHODES' PROOF OF CLAIM NO.
814-33 AND AMENDMENT OF SCHEDULES OF
ASSETS AND LIABILITIES FILED BY NILE
LEATHAM ON BEHALF OF REAORGANIZED
DEBTORS

U.S. Bankruptcy Court
300 Las Vegas Boulevard South
Las Vegas, Nevada 89101

November 4, 2010
9:35 a.m.

BEFORE THE HONORABLE LINDA B. RIEGLE, Judge

APPEARANCES:

For The Reorganized Debtors: Abid Qureshi
AKIN, GUMP STRAUSS HAUSER & FELD,
LLP
One Bryant Park
New York, New York 10036-6745

For James Rhodes: Kevin N. Anderson
FABIAN & CLENDENIN
215 S. State Street, Suite 1200
Salt Lake City, Utah 84111-2323

For The Rhodes Companies,
LLC: Zachariah Larson
LARSON & STEPHENS
810 S. Casino Center Blvd., #104
Las Vegas, Nevada 89101-6719

Proceedings recorded by electronic sound technician, Patricia
Lilly; transcript produced by AVTranz.

AVTranz

E-Reporting and E-Transcription
Phoenix (602) 263-0885 • Tucson (520) 403-8024
Denver (303) 634-2295

1 THE CLERK: Bankruptcy Court is now in session.

2 THE COURT: Proceed. All right, Rhodes appearances,
3 please.

4 MR. QURESHI: Good morning, Your Honor. Abid
5 Qureshi, Akin, Gump, Strauss, Hauer & Feld, on behalf of the
6 reorganized debtors.

7 MR. ANDERSON: Kevin Anderson, with Fabian &
8 Clendenin, on behalf of Mr. Rhodes.

9 THE COURT: All right. Okay. Go ahead. Oh. Sorry.
10 I note Mr. Larson's appearance.

11 MR. LARSON: Yes.

12 MR. QURESHI: Good morning, Your Honor. May I
13 proceed?

14 THE COURT: Yes, please.

15 MR. QURESHI: Your Honor, we are here this morning
16 pursuant to a stipulation entered into between the parties and
17 approved by the Court, concerning certain claims filed by Mr.
18 Rhodes. Today's hearing, pursuant to that stipulation, is
19 limited to the question of Mr. Rhodes' entitlement to the tax
20 claim.

21 Just to refresh Your Honor briefly, with the
22 underlying facts, Mr. Rhodes has asserted a claim in the amount
23 of \$9,700,029, approximately. The claim is on account of taxes
24 that Mr. Rhodes was obligated, as a matter of federal tax law,
25 to pay as a result of taxable income generated by three debtor

1 entities, Heritage Land, LLC, The Rhodes Companies, LLC, and
2 Rhodes Ranch General Partnership. Now the taxable income from
3 those three debtor entities, Your Honor, was passed through, to
4 three non-debtor entities, and those three non-debtors are
5 Sedora (phonetic) Holdings, LLC, Rhodes Ranch, LLC, and Sage
6 Brush Enterprises.

7 So the question before the Court, Your Honor, it
8 really is an entirely legal one, and it boils down to this, is
9 Mr. Rhodes a creditor, as defined in the bankruptcy code, does
10 he hold the claim, as those terms are defined in the code. So
11 let's start there.

12 Bankruptcy Code § 101, Supp. 10, defines creditor to
13 be an entity that has a claim against the debtor, that arose
14 prepetition. So of course the question then becomes, what is a
15 claim? 1015 of the Code, in turn broadly defines claim to be a
16 right of payment or a right to an equitable remedy for a breach
17 of performance if the breach gives rise to a payment.

18 Your Honor, the case law is indeed clear, that the
19 definition of claim that is used in the bankruptcy code should
20 have the broadest possible meaning, but the meaning is not
21 limitless. And I would refer Your Honor to the Supreme Court
22 decision in Next Wave. It's a 2003 case; it's cited in our
23 papers. And in that case what the Supreme Court says that the
24 right to payment means, in the definition of claim, in the
25 bankruptcy code, is, and I'm quoting, Your Honor, "nothing

1 more, nor less, than an enforceable obligation." And that
2 citation is 537 US 293 F. 303.

3 And so, Your Honor, the question here, the burden on
4 Mr. Rhodes, is to demonstrate that a debtor entity has an
5 enforceable obligation to reimburse Mr. Rhodes for a tax
6 payment that he made, on account of taxable income that was
7 passed through to him through the corporate structure of LLCs
8 and partnerships.

9 THE COURT: Now this is an aside --

10 MR. QURESHI: Yeah.

11 THE COURT: -- and I'm not sure what legal or
12 relevance this has. This was income that was passed through,
13 at a time when creditors were being -- were not being paid,
14 correct?

15 MR. QURESHI: I believe that is correct.

16 THE COURT: And so we have millions of creditors who
17 weren't paid -- well, the 23 million was passed through to him.

18 MR. QURESHI: That's correct.

19 So, Your Honor, before -- Mr. Rhodes advances three
20 principle arguments, as to why he's entitled to this claim.
21 First, he says that there's an equitable right, as a result of
22 a course of conduct that existed between Mr. Rhodes and various
23 of these -- of these entities. Second, he argues that the
24 governing documents of these LLCs and these partnerships
25 entitle him to this claim. And third, he points to a provision

1 in the First Lien credit agreement.

2 But, Your Honor, before I address each of those, and
3 each is without merit, and there are a couple of additional
4 arguments that are raised that I will also address, but I'd
5 like to spend a moment, if I could, Your Honor, just to
6 describe the pass-through structure, because I think it's
7 important to understand that.

8 The debtor entities that are involved here, they are
9 two LLCs and one partnership. And for tax purposes, and this
10 is a function of federal tax law, these entities are what is
11 described as pass-through entities. What that means is that
12 the entities, themselves, do not have the tax obligation. The
13 tax obligation flows through the entities, to, in the case of
14 LLCs, the members, and in the case of a partnership, of course
15 the partners.

16 Thus, the debtor entities, themselves, have no
17 obligation to pay taxes on any of the taxable income that they
18 generate. It is the individual behind those entities, in this
19 case, Mr. Rhodes, that bears the ultimate responsibility, as a
20 matter of federal tax law, and this is not disputed, to pay the
21 taxes, on account of the taxable income generated.

22 So the obligation exists, the obligation of Mr.
23 Rhodes, as the LLC member, or as the partner in these entities,
24 to pay the federal income taxes. That exists, irrespective of
25 whether Mr. Rhodes receives a distribution from the LLC or a

1 distribution from the partnership, in an amount equal to the
2 taxes, it does not matter. Again, undisputed, as a matter of
3 federal tax law, he owes the taxes, period, full stop.

4 So what Mr. Rhodes has to demonstrate, in order to
5 have a claim here, is that the debtor entities were mandated,
6 were required, to reimburse him for these tax payments. He can
7 show that in three ways. He can show that there is a statutory
8 requirement that the debtor entities make a distribution equal
9 to the taxes paid; he can show that there's a provision in the
10 operative document of the debtor entities, the LLCs or the
11 partnership agreements, that require that kind of distribution
12 when he makes a tax payment; or third, he can point to a
13 decision by the LLC members or the partners in the partnership,
14 to make a distribution. And he fails on all three.

15 And there is a case that we refer to in our pleadings
16 that I think is particularly helpful in understanding this
17 framework that I'd like to spend a minute on. It's of course
18 not by any precedent, but it's instructive nonetheless. It's
19 the Five Star Concrete case. It's from the Indiana Court of
20 Appeals. And there, Your Honor, that Court considered the
21 question of whether a member who was withdrawing from an LLC
22 had a right to a distribution from the LLC in an amount equal
23 to the pass-through taxes that that entity was required to pay.

24 So same structure under Indiana law. The LLC is a
25 pass-through, the members of it have to pay the taxes, this

1 withdrawing member had to pay the taxes and was now looking for
2 a distribution from the LLC in an amount equal to the taxes.
3 Here's what the -- how the Indiana Court analyzed it, and I
4 submit, Your Honor, that it's the right way to analyze it here.

5 First, the Court looked to applicable Indiana
6 statutes, to see if there was any requirement that a LLC make a
7 distribution to a member, on account of income taxes paid, and
8 there was no such requirement in Indiana law, and as I'll get
9 to in a moment, there's no such requirement under Nevada law,
10 which is applicable here.

11 Second, the Court looked to the operative documents
12 of the LLC, to see if, in those operative documents, there was
13 a requirement that the LLC make a distribution, and again, as
14 here, there was not. And finally, the Court found that there
15 was no decision that was taken, on behalf of the LLC, to make
16 the distribution. And thus, the withdrawing member was -- you
17 know, still had to pay the taxes, because that was the
18 withdrawing member's obligation, as a function of federal tax
19 law, but was not entitled to a distribution, on account of that
20 payment. And the reason is identical here.

21 So let's start with the first prong, is there a
22 statutory requirement that obligates the debtor entities to
23 make a distribution to Mr. Rhodes on account of these taxes?
24 And the answer is again not disputed; there is no such
25 requirement. The applicable provisions of the Nevada statute

1 provide that the right of a partner, in a partnership, or the
2 right of a member in an LLC, to receive a distribution is
3 governed by the operative documents of the entity, and of
4 course by whether there is a decision by the LLC or the
5 partnership to make a distribution. There is no independent
6 obligation, nor is there argued to be, as a function of Nevada
7 law, that requires a distribution to be made in certain
8 circumstances.

9 So that takes us, then, to the governing documents.
10 And again, here the question is, is there an affirmative
11 obligation, in the governing documents, for the debtor entities
12 to make a distribution to Mr. Rhodes, when Mr. Rhodes fulfills
13 his obligations to make a federal tax payment. Now Mr. Rhodes
14 points, first, to the operating agreement of Sedora Holding,
15 LLC. Now just as an aside, we've never seen the operating
16 agreement. We've asked for it. It hasn't been provided to us.
17 As far as I'm aware, it hasn't been provided to the Court.

18 But what they say in the papers is that, and they
19 quote a provision of that agreement, that that agreement
20 mandates distributions to partners in an amount sufficient for
21 the partners to pay their tax liabilities. The problem, Your
22 Honor, is that Sedora Holdings is a non-debtor entity, so it's
23 irrelevant what the operating agreement -- the operating
24 documents of a non-debtor entity says has no force, of course
25 with respect to the Debtors. The obligation to pay has to be an

1 obligation of the debtor entity, in order for it to be a claim.
2 And here, it clearly isn't.

3 So turning then, to the operative documents that
4 actually do matter, which are of course the operating documents
5 of the debtor entities, and this is important, Your Honor. Mr.
6 Rhodes concedes in his papers that those documents do not
7 mandate a distribution. He quotes from the documents and
8 correctly concludes that those documents are permissive,
9 they're not mandatory. They allow for that type of a
10 distribution to be made, but they do not mandate. So again,
11 undisputed, there is no requirement in the operative documents
12 of the debtor entities for this type of a distribution to be
13 made.

14 Next, Mr. Rhodes refers to the first-line credit
15 agreement. And again, even ignoring, for the moment, whether
16 that's even a relevant provision to look at, the first-line
17 credit agreement, similarly, has no affirmative requirement, on
18 a debtor entity, to make a distribution to Mr. Rhodes, on
19 account of tax payments, it is permissible. And again, not
20 disputed, Your Honor.

21 Mr. Rhodes, in his papers, describes the provision in
22 the first-line credit agreement as an enabling provision, and
23 that's exactly what it is. It basically says if the LLC or a
24 partnership, if the debtor entity wishes to make that kind of a
25 distribution, it's not prohibited by the first-line credit

1 agreement. That is not an affirmative obligation of the
2 Debtor, to make the distribution, not even close.

3 So in accordance with the Five Star Concrete case,
4 and how that case looked at it, Your Honor, that ends the
5 inquiry. There's no statutory obligation, there's no
6 obligation in the operative documents of the debtor entities,
7 and there also has been no decision made by the debtor
8 entities, to make the distribution. And all three of those
9 points are undisputed.

10 Now Mr. Rhodes advances a couple of additional
11 arguments that I think are easily dismissed, and I'll deal with
12 quickly, if I may. First, his papers actually begin with a
13 rather lengthy recitation of the right to offset the tax claim.
14 And, Your Honor, that's simply putting the cart before the
15 horse. Of course, before there's a right to offset, you have
16 to have a claim. And so we didn't get into, in our papers, the
17 question of whether there's an offset right, here, because
18 again, it's not a relevant question until there's a
19 determination that he actually has a claim. But certainly, the
20 right to offset cannot, in itself, create a claim, needless to
21 say.

22 Second, Mr. Rhodes points to the statements and
23 schedules that were filed by the Debtor, and suggest that in
24 these statements and schedules, there was somehow a binding
25 judicial admission that these payments were owed. So let me

1 just briefly review the facts.

2 On March 31, of 2009, which was, for most of the
3 Debtors, the petition date. It was March 31 or April 1. On
4 March 31, at a time when of course Mr. Rhodes was in control of
5 the Debtors, there was a ledger entry made, in the Debtors'
6 books and records, that reflected an amount owing to Mr. Rhodes
7 of \$9.7 million, an amount equal to the tax payment. The day
8 before the petition or the day of the petition.

9 A month later, on April the 30th, of 2009, the
10 Debtors, again at a time when Mr. Rhodes was in control, filed
11 their first statements and schedules, and they did so in
12 reliance on a general ledger that was done as of the petition
13 date, and so those statements and schedules reflected the same
14 thing, an amount owing to Mr. Rhodes, equal to the tax claim.

15 So those original schedules, Your Honor, on April
16 30th, and every iteration of the schedules that was filed
17 thereafter, contained a very clear reservation of rights of the
18 Debtors, that said that the Debtors expressly reserve the right
19 to dispute any claim reflected on its schedules, as to amount,
20 as to liability, as to classification. That reservation was
21 there every time. Likewise, Your Honor, in the plan there's a
22 similar reservation. There, the debtor entities again
23 expressly reserve the right to object to any and all claims.
24 So on their face, these schedules are not binding.

25 But lastly, Your Honor, the schedules don't

1 constitute a judicial admission. I mean separate and apart
2 from all of the reservations that clearly say that the Debtors
3 are reserving their right to object. And for obvious reasons,
4 bearing in mind that Mr. Rhodes was in control when those were
5 created. They're not pleadings. Their contents are therefore
6 not judicial admissions. They were filed in the general
7 bankruptcy case, pursuant to Bankruptcy Code § 521. They were
8 not filed in connection with a specific contested matter, with
9 an adversary proceeding, and as such, they don't constitute a
10 judicial admission.

11 Last point, Your Honor, the equitable claim. And
12 again, here Mr. Rhodes is arguing that as a result of a past
13 practice that he alleges took place, the debtor entities
14 should, now in bankruptcy, continue to be obligated to
15 reimburse him for the tax payment. There's a fundamental
16 problem, though, with his argument.

17 The course of conduct that is alleged, the course of
18 conduct that is described in Mr. Rhodes' pleadings, and I'm
19 going to quote, briefly, from the pleading, where he says,
20 quote, "Sage Brush calculated the incomes and losses allocated
21 to Rhodes, and subsequently made payments to the IRS on behalf
22 of Rhodes, in satisfaction of Rhodes' federal income tax
23 liability." Mr. Rhodes points to that history and says,
24 therefore, the debtor entities here have the same obligation.

25 The problem, Your Honor, is Sage Brush is a non-

1 debtor. And so a course of conduct between Mr. Rhodes and a
2 non-debtor entity controlled by him is utterly irrelevant to
3 the question of whether that should somehow form the basis for
4 the Debtors, as a matter of equity, to have an obligation here.

5 But even if it was a course of conduct engaged in by
6 the debtor entities, Your Honor, I would submit that it is not
7 even close, as a matter of equity, as to whether the debtor
8 entities ought to be obligated to reimburse Mr. Rhodes for that
9 payment. The payments, to the extent that they may have been
10 made in the past, were purely discretionary. And again, we get
11 there by looking at the undisputed operative documents of the
12 debtor entities, which do not contain an affirmative obligation
13 to make the payments. And so those documents, and any past
14 practice, are insufficient to create an obligation, in
15 bankruptcy, on the debtor entities.

16 So the other point, Your Honor, that I think entirely
17 dismisses this argument is that it's Mr. Rhodes' obligation, as
18 a matter of federal tax law, again undisputed. It's his
19 obligation to make these payments, and nobody else's. That is
20 not an obligation of the debtor entities. So for all those
21 reasons, Your Honor, we think that the claim should be
22 disallowed and expunged.

23 THE COURT: Okay.

24 MR. QURESHI: If Your Honor has any questions.

25 THE COURT: No. Thank you. Okay. Opposition.

1 MR. ANDERSON: Good morning, Your Honor. Perhaps one
2 important clarification, based on your question, there is no
3 money that passed through Mr. Rhodes, at a time when people
4 were not being paid. This is just a line entry on the books
5 and records of one of the debtor entities, that recognized this
6 obligation. So there was no transfer of actual cash to Mr.
7 Rhodes.

8 He paid the \$9.7 million in tax liability out of his
9 own pocket, based on the understanding that he was entitled to
10 reimbursement, which at this point, as we've stated our papers,
11 we do not even seek, as a claim against the estate, for
12 purposes of receiving any portion of the payment be made by the
13 estate, but only as a set-off against any future claims that
14 may be made against Mr. Rhodes. That was the purpose of our
15 going into the set-off provisions.

16 Let me start with Number 3, of the ways that we could
17 -- that Mr. Abid Qureshi stated that we could establish Mr.
18 Rhodes's claim, and that was a decision to make the
19 distribution. That one was kind of glossed over awfully
20 quickly. The definition of a claim, as I think the reorganized
21 debtors would want you to read, they would want you to read
22 only every other word, it is not a right to a payment, that is
23 reduced to a liquidated, fixed, matured, undisputed legal
24 right. That's not the code. The code establishes that it is a
25 right to payment, whether or not such right is reduced to a

1 judgment, a liquidated or unliquidated, a fixed or a
2 contingent, a matured or a disputed, undisputed legal or
3 equitable, or an unsecured right.

4 Our fundamental basis for proving to this Court, at
5 this point, that as a matter of law this claim can continue,
6 but we're not here with evidence and discovery, to get to the
7 substance of these issues. It is the equivalent, I think, of a
8 motion to dismiss, as whether there is -- you know, a probable
9 ground for Mr. Rhodes to be able to establish that he is
10 entitled, under state law. We don't disagree with that.

11 And I think that the single fact that should change
12 everything, in the Court's mind, is the fact that before the
13 bankruptcy was filed, whether that was a minute before, a day
14 before, a week, a month, a year before, one of the debtor
15 entities, controlled through Sage Brush, so the fact that Sage
16 Brush had done this in the past is relevant, one of the debtor
17 entities entered, into its books and records, this liability.
18 That fact is important. That fact should be recognized by the
19 Court. You know, that fact is one that the reorganized debtors
20 are stuck with, because it --

21 THE COURT: Well, why not have an affidavit or
22 anything that says that it was more than some bookkeeper who
23 sees this number here, and says, "Oh, gosh. I guess I should
24 put it in the ledger."

25 MR. ANDERSON: Well, we --

1 THE COURT: You're relying on a decision. Why don't
2 I have anything -- you know, okay, he's talking to himself, but
3 you still have to go through procedures, to make a decision.
4 Why don't I have that?

5 MR. ANDERSON: I believe that's in Mr. Rhodes's
6 declaration, that that was the purpose for that entry. I don't
7 think anybody opposes the fact that that was for the purpose.
8 In fact, I'll have to check our stipulated facts,
9 acknowledge -- well, that just that it contains the ledger, the
10 ledger entry was all that was stipulated to. But it is in the
11 exact amount that we're claiming, and you know, those facts --
12 you know, that now gets into the factual process of the
13 decision of making that.

14 THE COURT: Well, doesn't that also raise issues of
15 his breach of fiduciary duty?

16 MR. ANDERSON: It absolutely could, but I -- but, you
17 know, that's not an issue for this, on the legal issue of
18 whether or not he is entitled to pursue this claim, and we can
19 get into factual issues about whether he breached his fiduciary
20 duty in doing that. You know, our statement -- version of the
21 facts and understanding of the facts is that this was a
22 practice that was allowed, that had been previously done, that
23 Mr. Rhodes had relied on, and that was approved by the
24 necessary entities, however --

25 THE COURT: Where is that, in the affidavit?

1 MR. ANDERSON: -- however casually.

2 THE COURT: Where is that, in the affidavit? I mean
3 I'm not saying it's not there, I just want you to tell me where
4 it is in the affidavit. And my intent was, that when you did
5 this new briefing you were to not rely on old affidavits, but
6 to reattach them if necessary, so I wasn't quammung (phonetic)
7 through all those old pleadings.

8 MR. ANDERSON: I apologize. I believe we did cite to
9 the declaration one or two places. Because the stipulated
10 facts obviously didn't cover 100 percent of the facts.

11 In paragraph 21 of Mr. Rhodes's declaration, I have
12 it on page 8.

13 THE COURT: Is that document 1177?

14 MR. ANDERSON: Yes.

15 THE COURT: Okay.

16 MR. ANDERSON: Mr. Rhodes states that, in the text,
17 in the 2006 tax year, estimated tax payments attributable to
18 Rhodes corporate structure amounted to 14-plus million, which
19 were paid --

20 THE COURT: I'm sorry. Which paragraph again?

21 MR. ANDERSON: Excuse me?

22 THE COURT: Which paragraph?

23 MR. ANDERSON: Oh. 21. It's 21.

24 THE COURT: 21.

25 MR. ANDERSON: I have it on page 8.

1 THE COURT: Okay.

2 MR. ANDERSON: In 2006, the estimated income tax
3 payments attributable to the Rhodes corporate structure
4 amounted to \$14 million, were paid by Sage Brush in or around
5 late 2007, upon completion of the tax return, to the Rhodes
6 corporate structure, for that tax year. It became clear that
7 the total tax liability for the 2006 tax year was increased by
8 the estimated tax payments. Therefore, approximately 9.7
9 million of his cash reserves were used to satisfy the remaining
10 tax liability for 2006. And such payment was accounted for in
11 the books and records as a dividend payable to me.

12 THE COURT: Well, he says it's a course of conduct.
13 He didn't say a word about a decision.

14 MR. ANDERSON: Well, no. He is saying that --

15 THE COURT: Read the next sentence.

16 MR. ANDERSON: Yeah, remained accrued and unpaid for
17 those according on the form --

18 THE COURT: Demonstrate a course of conduct. He
19 never once used the word, "I made the decision," the decision
20 was made.

21 MR. ANDERSON: Well, I think that a course of conduct
22 -- granted, Your Honor, but the course of conduct is a viable
23 basis for that to be reflected on the books and records. It
24 being reflected on the books and records is a recognition of
25 the course of conduct.

1 THE COURT: Why was it done one day before the
2 filing?

3 MR. ANDERSON: I don't know, Your Honor. That could
4 be a matter of discovery, as to a breach of fiduciary duty, or
5 other issues. I don't -- I honestly don't know when the tax
6 records were prepared and when the liability was incurred.

7 THE COURT: Okay. All right.

8 MR. ANDERSON: Anyway, the -- I think that the fact
9 that the debtor entity, on their books and records, on their
10 schedules, recognize this obligation, they knew what the
11 purpose of the obligation was, is all we need, to get by this
12 stage of the proceedings.

13 That fact, for example, clearly distinguishes this
14 case from the Five Star case. If the Court reads the Five Star
15 case in detail, as we point out in our brief, that was a
16 situation, it was not a closely held corporation. There was
17 no --

18 THE COURT: Well, what if I had -- let's take a fact
19 situation where let's assume a company illegally made
20 distributions to its partner every year, every year for ten
21 years. And it was clearly illegal, because there were
22 creditors to be paid, there was no right to dividends under the
23 operating agreements. Aren't you saying that that course of
24 conduct means they have a right to payment?

25 MR. ANDERSON: No. I would agree with the

1 reorganized debtors, that the governing documents would
2 control. If it is not allowed, under the governing documents,
3 if it is an improper payment, then no, that would not be a
4 viable course of conduct.

5 What we have here are permissive governing documents.
6 They don't disallow it, they don't say you can't do it, they
7 say you can do it. They don't say that you have to do it. But
8 they say that you can. And the fact that they did, as
9 reflected on the books and records, is all the we need, to
10 establish a -- you know, disputed, unliquid -- you know,
11 equitable claim at this point.

12 I acknowledge that we have a bit of an uphill road,
13 in terms of evidence and proof, but I believe that we can meet
14 those, based on the past practice, and when we dive into the
15 events -- you know, that happened on March 31st, when that was
16 recorded on the books and records, and what everybody's
17 understanding was. You know, understanding, you know, as the
18 Court just did, it would essentially be Mr. Rhodes talking to
19 himself.

20 You know, I would assert the premise, you know, here,
21 for purposes of argument, that the fact that even in his own
22 mind, as the controlling -- the person who controlled Sage
23 Brush, which --

24 THE COURT: So you would say that he would knowingly
25 breach his fiduciary duty, in order to give himself this

1 payment.

2 MR. ANDERSON: How does he breach a fiduciary duty
3 when he owns a hundred percent of Sage Brush. Sage Brush --

4 THE COURT: When creditors aren't paid.

5 MR. ANDERSON: Well, what fiduciary duty does he have
6 to creditors?

7 THE COURT: A deepening insolvency.

8 MR. ANDERSON: Well, you know, that -- then you have
9 questions of maybe fraudulent conveyance. But nothing was
10 conveyed here. Just this obligation. We're not trying to get
11 the money away from anybody.

12 THE COURT: Well, he was then. You've just now
13 changed your mind and said you want it merely as an offset.

14 MR. ANDERSON: Yeah. Well, he --

15 THE COURT: If he filed his claim and he wanted a
16 claim, he wasn't seeking as an offset. He was seeking to be
17 paid the money.

18 MR. ANDERSON: But -- I mean he paid the money out
19 and he felt he was entitled to it, because -- based on past
20 practices. And it was something that was allowed. The
21 reorganized debtor, you know, in their prior life, as the
22 creditors, also permitted this, in the credit agreement. They
23 didn't prohibit it. If it was something that so offends them,
24 that he would do this, whether it's at the -- the minute before
25 he files for bankruptcy or if it was a year before he filed for

1 bankruptcy, they could've precluded it. They did not. They
2 allow it. It is permitted. He did nothing wrong, based on the
3 facts that the Court has before it right now. This was a
4 completely permissible action. It is reflected on the books
5 and records, and it presents a viable legal claim.

6 THE COURT: Okay.

7 MR. ANDERSON: If there's no further questions, I
8 think --

9 THE COURT: No. Thank you.

10 MR. ANDERSON: I think that's the heart of our
11 position.

12 THE COURT: Yes, you're right, Thank you.

13 THE COURT: Reply?

14 MR. QURESHI: Your Honor, may I briefly respond?

15 THE COURT: Yes, please.

16 MR. QURESHI: Thank you.

17 Your Honor, a couple of quick points. First, let's
18 bear in mind, when this tax claim arose. This is in respect of
19 Mr. Rhodes' tax obligations for the tax year 2006.

20 So what we have is a ledger entry, by Mr. Rhodes, or
21 people that he controlled, on the day of the filing. No
22 reference of Mr. Rhodes' affidavit, to any resolution of the
23 LLC or decision of the LLC or the partnership, back in 2006 or
24 2007 or even 2008, at the time that the obligation arose, but
25 instead, just a ledger entry on the eve of the filing. And in

1 Mr. Rhodes' declaration, as Your Honor pointed out, he
2 specifically says, therefore, it establishes a course of
3 conduct.

4 Counsel, in argument, and in Mr. Rhodes' papers,
5 concedes that this is an equitable argument. And therefore, it
6 bears noting why we're here, Your Honor. We're here because
7 Mr. Rhodes understands the risk he faces, of lawsuits, or among
8 other things, breach of fiduciary duty, et cetera, as a result
9 of his failure to pay creditors, et cetera, at a time when he
10 was taking distributions. And what Mr. Rhodes is looking for
11 is for the ability to set off the first almost \$10 million of
12 any judgment that should be entered against him down the road.
13 That right there, Your Honor, should put an end to the notion
14 that he should be entitled to any equitable relief from this
15 Court.

16 Your Honor, the other point, counsel referred Your
17 Honor to the definition of a claim, and we don't dispute that
18 the definition of claim is indeed a broad one, and we certainly
19 don't dispute the case law that is cited. Indeed, in the
20 Supreme Court decision, Your Honor, in Next Wave, the Court
21 goes through all of the case law on how broad he definition of
22 a claim is, and then concludes, notwithstanding that it's
23 liquidated or unliquidated, disputed or undisputed, legal or
24 equitable, et cetera, but at the end of the day, what the
25 phrase, "right to payment," means is nothing more, nor less,

1 than an enforceable obligation. Enforceable obligation on the
2 debtor.

3 Here, there's no statute; here, there's no obligation
4 in the governing documents, but there's an admission that those
5 are merely permissive. So I fail to understand, Your Honor,
6 how a ledger entry made three years after the tax obligation,
7 after the fact, could somehow constitute an enforceable
8 obligation of an LLC, or of a partnership, to make that type of
9 a distribution, when there is not a stitch of evidence in the
10 governing documents. To the contrary. There's an admission
11 that the governing documents have no such obligation. That
12 cannot arise to the type of an enforceable obligation that the
13 Supreme Court says there must be, in order for there to be a
14 claim.

15 THE COURT: Okay.

16 MR. QURESHI: Thank you.

17 THE COURT: All right, thank you.

18 Well, I agree with the reorganized debtors, and will
19 sustain the objection, insofar as precluding any right of said
20 offset, under Section 553. As counsel has pointed out, and I'm
21 not saying anyone's disagreeing, but just to kind of go through
22 the elements, a setoff is allowed, but it doesn't create a
23 right of setoff. In order to be allowed the setoff, there must
24 be mutual claim and mutual debt. Here, a claim, the point,
25 again, as counsel has indicated, it's a right to payment. And

1 here, we have -- I don't believe Mr. Rhodes has established a
2 right to payment of the taxes that he paid.

3 As the parties have stipulated, in the first
4 instance, it is his obligation to pay those taxes, as the pass-
5 through entity. Secondly, there's no statute which requires
6 the LLC or partnership to pay the taxes. Next, the documents,
7 operating documents, do not require it. They permit it, but do
8 not require it. And finally, to the extent that there was a
9 decision, it seems to me it looks -- you've got to prove to me
10 it's an enforceable decision.

11 And I know we're at summary judgment stage, but --
12 the equivalent of summary judgment, but you've got to come
13 forward with something to show me it would be some sort -- a
14 decision was made, at the time of the events in question, that
15 the entity would pay it, and that's not here. His affidavit
16 speaks only of course of conduct. And the course of conduct,
17 what's happened in the past, wouldn't even regulate what
18 happens now.

19 So let's assume, for example, over the past 20 years
20 the entity has always paid the taxes. But now we're in hard
21 times, and he may well -- they may well have decided, "No. The
22 entity is not going to pay the taxes, because we are in hard
23 times." So the course of conduct does nothing to establish
24 what is happening now, and what happened.

25 Also, the fact of the three years in between, the

1 fact there was a ledger in a one day before bankruptcy, to me
2 not only doesn't prove that there was a decision made, that he
3 was liable -- that the entity would pay the taxes, but it works
4 against him. It's certainly non-judicial admission, in light
5 of the reservation of rights. In any event, I believe judicial
6 admissions, under Nevada law, are merely presumptions, and
7 which can be rebutted in any case. And I know we're in a
8 federal case, but I think the evidence rules pick up the
9 presumptions of state law. So for all those reasons, I find
10 that the -- Mr. Rhodes is not entitled to offset, against any
11 judgment, the tax liability.

12 Now where do we go from here, on the rest of this?
13 Do you want to certify this court's decision, do you want to
14 just go on with the rest of the trial, do you want a
15 settlement? What do we want to do?

16 MR. QURESHI: Your Honor, the thinking, and
17 bifurcating, because this was by far the largest part of the
18 claims.

19 THE COURT: Sure.

20 MR. QURESHI: Once we resolve this, it would
21 hopefully enable a settlement of the remaining much smaller
22 claims. That continues to be our hope. So what I would
23 suggest is let's submit an order, with respect to this piece,
24 allow the parties a little bit of time to discuss settlement of
25 the remaining claims. Maybe what we ought to do, just in case,

1 is get a date on the calendar, if we may, for those remaining
2 claims, but hopefully within a week or two we'll be able to
3 work those out.

4 THE COURT: Okay. In January, we're going to be, and
5 February, we're going to be in good shape, as far as settlement
6 judges go.

7 MR. QURESHI: Okay.

8 THE COURT: In January or February I can give you
9 Judge Ross, Judge Peterson, and indeed Judge Zive. So you tell
10 me what your -- do you want to -- do you want me to tell you
11 the weeks that are available, and you can talk about it and let
12 us know?

13 MR. ANDERSON: Yeah. I think Bret (phonetic) may
14 actually be handling those, but why don't we get some tentative
15 dates --

16 MR. QURESHI: Yeah. It --

17 MR. ANDERSON: -- and we can pass those on to her.

18 THE COURT: Sure. Judge Ross is available the week
19 of January 10th. Judge Peterson is available the week of the
20 24th. Judge Ross is available the week of February 14th.
21 Judge Peterson, the week of January 22nd.

22 MR. ANDERSON: January or February?

23 THE COURT: February. Excuse me. And then I'll do
24 March too. Judge Ross, March 7th. Judge Peterson, March 21st.
25 Judge Zive, we don't have a particular schedule for him, but he

1 can do settlements in Reno, whether you can arrange to go to
2 Reno --

3 MR. ANDERSON: Sure.

4 THE COURT: It's probably easier, since everybody is
5 from -- well, if Mr. Rhodes is involved -- well, in any event,
6 you can go to Reno or he will be down here at some point.

7 MR. QURESHI: Do you specific availability for Judge
8 Zive?

9 THE COURT: I don't have his specific --

10 MR. QURESHI: Okay.

11 THE COURT: -- dates. His office does.

12 MR. QURESHI: Okay. So are we permitted to contact
13 his office?

14 THE COURT: Yes. You may contact Linda Duffy up
15 there.

16 MR. QURESHI: Okay.

17 THE COURT: He is going -- he'll be on recall, so
18 he'll still take -- January is probably going to be hard for
19 him, because he'll be taking -- he's keeping his old cases and
20 taking the new judge's conflicts, if any.

21 MR. QURESHI: Okay.

22 THE COURT: And I know he's already arranged a couple
23 of settlement conferences for me, in Reno, for other cases. So
24 -- but you may contact him directly, if you want to use him
25 instead.

1 MR. QURESHI: I appreciate it, Your Honor.

2 THE COURT: Okay?

3 MR. QURESHI: Thanks very much.

4 THE COURT: All right. Thank you very much. And
5 then I guess you'll come back on the status, telephonic, in a
6 few weeks, to let me know what you want to do?

7 MR. QURESHI: Sure.

8 MR. ANDERSON: Yeah. Probably.

9 THE COURT: Okay.

10 MR. QURESHI: That makes sense.

11 MR. ANDERSON: And just to make clear, in terms of
12 certifying, you know we would certainly reserve the right to
13 ask the Court to certify this issue.

14 THE COURT: Sure. I only mention that just
15 because --

16 MR. ANDERSON: Yeah.

17 THE COURT: -- you know, that's an option you may
18 want to consider.

19 MR. ANDERSON: We went off on the settlement, so I
20 just want to make sure we would reserve that.

21 THE COURT: Sure.

22 MR. ANDERSON: We're not waiving it, obviously.

23 THE COURT: Sure.

24 MR. QURESHI: So, Your Honor, we'll upload an
25 appropriate order for Your Honor's review.

1 THE COURT: You can just say for the findings and
2 conclusions set forth in the record.

3 MR. QURESHI: Perfect. Okay.

4 THE CLERK: Your Honor, can we set a couple ominous
5 dates, just for those objections to the claims, or anything
6 else that may need to come up?

7 THE COURT: These people are the wrong people. They
8 won't know the dates available. You don't anticipate any --
9 well, you might. Do you know, are Rhodes matters --

10 MR. QURESHI: Well, Your Honor, I was mentioning,
11 earlier, that I spoke with Ms. Cho yesterday, and she indicated
12 that we would need at least one additional hearing date, to
13 deal with some remaining --

14 THE COURT: Oh, all right.

15 MR. QURESHI: -- claims objections. I'm not exactly
16 sure what those claims are, but --

17 THE COURT: Do you want December?

18 MR. QURESHI: Yes. I think that'd be fine.

19 THE COURT: December 17th? Does that work?

20 MR. QURESHI: That does work, Your Honor.

21 THE CLERK: At 9:30?

22 MR. QURESHI: Sure. It's ideal. Your Honor --

23 THE COURT: And so in any event, we'll do a
24 telephonic on this, that day.

25 MR. QURESHI: That's perfect.

1 THE COURT: Okay. And put in your order, at the end,
2 that there'll be a status hearing, and that you both may appear
3 telephonically.

4 MR. QURESHI: Okay.

5 THE COURT: So that refreshes our recollection that
6 you don't need to write in for permission.

7 MR. QURESHI: Perfect. And, Your Honor, with respect
8 to that December 17th date, if I may, just immediately after
9 this hearing contact Mr. Cho, to make sure that works for her.

10 THE COURT: Sure.

11 MR. QURESHI: And if I don't contact the Court,
12 assume that that's fine.

13 THE COURT: Oh, you know, we could do it on December
14 16th. I've got USA, but they're just dribs and drabs now,
15 aren't they? We could do it -- here's your option. December
16 16th at 10:30, or December 17th at 9:30.

17 MR. QURESHI: Okay.

18 THE COURT: And just let the clerk know -- and
19 whatever date you put in the order will be fine.

20 MR. QURESHI: Perfect.

21 THE COURT: Okay.

22 MR. QURESHI: Thank you very much, Your Honor.

23 THE COURT: All right, thank you.

24 MR. ANDERSON: Thank you, Your Honor.

25 (Proceedings Concluded)

1 I certify that the foregoing is a correct transcript from
2 the record of proceedings in the above-entitled matter.

3
4 Dated: November 22, 2010

Melissa Seabaugh

AVTranz, Inc.
845 N. Third Avenue
Phoenix, AZ 85003